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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9557]

RIN 1545-BF27

Application of Section 108(e)(8) to Indebtedness Satisfied by a Partnership Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the application of section 108(e)(8) of the Internal Revenue Code (Code) to partnerships and their partners. These regulations provide guidance regarding the determination of discharge of indebtedness income of a partnership that transfers a partnership interest to a creditor in satisfaction of the partnership's indebtedness. The final regulations also address the application of section 721 to a contribution of a partnership's recourse or nonrecourse indebtedness by a creditor to the partnership in exchange for a capital or profits interest in the partnership. Moreover, the final regulations address how a partnership's discharge of indebtedness income is allocated as a minimum gain chargeback under section 704. The regulations affect partnerships and their partners.

DATES: Effective Date: These regulations are effective on **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

Applicability Date: For dates of applicability, see §§1.108-8(d), 1.704-2(l)(1)(v), and 1.721-1(d)(4).

FOR FURTHER INFORMATION CONTACT: Joseph R. Worst or Megan A. Stoner, Office of Associate Chief Counsel (Passthroughs and Special Industries), (202) 622-3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

This document contains amendments to 26 CFR part 1 under sections 108, 704, and 721 of the Code relating to the application of section 108(e)(8) to partnerships.

Section 108(e)(8) was amended by section 896 of the American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat. 1648), to include discharges of partnership indebtedness occurring on or after October 22, 2004. Prior to the amendment, section 108(e)(8) only applied to discharges of corporate indebtedness. Section 108(e)(8), as amended, provides that, for purposes of determining income of a debtor from discharge of indebtedness (COD income), if a debtor corporation transfers stock or a debtor partnership transfers a capital or profits interest in such partnership to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation or partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock or interest. In the case of a partnership, any COD income recognized under section 108(e)(8) shall be included in the distributive shares of the partners in the partnership immediately before such discharge.

A notice of proposed rulemaking and a notice of public hearing (REG-164370-05, 2008-46 IRB 1157) were published in the **Federal Register** (73 FR 64903) on October 31, 2008, proposing amendments to the regulations regarding the application

of section 108(e)(8) to partnerships and their partners, including the determination of COD income of a partnership that transfers a partnership interest to a creditor in satisfaction of the partnership's indebtedness (debt-for-equity exchange). The proposed regulations also provide that section 721 generally applies to a contribution of a partnership's recourse or nonrecourse indebtedness by a creditor to the partnership in exchange for a capital or profits interest in the partnership. A public hearing on the proposed regulations was scheduled for February 19, 2009, but was cancelled because no one requested to speak. However, comments responding to the proposed regulations were received. After consideration of these comments, the proposed regulations are adopted as revised by this Treasury decision. These final regulations generally retain the provisions of the proposed regulations with the modifications discussed in the preamble.

## **Summary of Comments and Explanation of Provisions**

### **1. Valuation of Partnership Interest Transferred in Satisfaction of Partnership Indebtedness**

Section 108(e)(8) provides that, for purposes of determining COD income of a debtor partnership, the partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the interest transferred to the creditor. Generally, the amount by which the indebtedness exceeds the fair market value of the partnership interest transferred is the amount of COD income required to be included in the distributive shares of the partners that were partners in the debtor partnership immediately before the discharge.

The proposed regulations provide that, for purposes of determining the amount of COD income, the fair market value of the partnership interest transferred to the creditor

in a debt-for-equity exchange (debt-for-equity interest) is the liquidation value of the partnership interest if four requirements are satisfied (liquidation value safe harbor). For this purpose, liquidation value equals the amount of cash that the creditor would receive with respect to the debt-for-equity interest if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles) for cash equal to the fair market value of those assets, and then liquidated.

The four conditions of the liquidation value safe harbor in the proposed regulations are that (i) the debtor partnership determines and maintains capital accounts of its partners in accordance with the capital accounting rules of §1.704-1(b)(2)(iv) (capital account maintenance requirement); (ii) the creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange (consistency requirement); (iii) the debt-for-equity exchange is an arm's-length transaction (arm's-length requirement); and (iv) subsequent to the debt-for-equity exchange, neither the partnership redeems nor any person related to the partnership purchases the debt-for-equity interest as part of a plan at the time of the debt-for-equity exchange which has as a principal purpose the avoidance of COD income by the partnership (anti-abuse provision). If these requirements are not satisfied, all of the facts and circumstances are considered in determining the fair market value of the debt-for-equity interest for purposes of applying section 108(e)(8). Each of the four requirements of the proposed regulations is discussed in the preamble.

The first requirement is the capital account maintenance requirement.

Commenters requested that the final regulations clarify that this requirement does not necessitate compliance with all aspects of the substantial economic effect safe harbor under §1.704-1(b)(2), notably the requirement that the partnership liquidate in accordance with the positive capital account balances of its partners. To eliminate confusion over the capital account maintenance requirement in the liquidation value safe harbor, the IRS and the Treasury Department have decided to remove the capital account maintenance requirement from the liquidation value safe harbor because the maintenance of capital accounts is not necessary to the determination of the liquidation value of the partner's interest.

The second requirement of the liquidation value safe harbor in the proposed regulations is the consistency requirement. This requirement is intended to ensure consistent reporting by the creditor, debtor partnership, and its partners. One commenter suggested narrowing the scope of this requirement in the final regulations so that the failure of a partner to consistently treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest does not invalidate the partnership's use of the liquidation value safe harbor, provided the creditor and the partnership otherwise consistently determine and report COD income based on such valuation. The IRS and the Treasury Department considered the issue and decided to not modify this requirement in the final regulations. The amount of COD income computed under the liquidation value safe harbor may differ from the amount computed using the fair market value of the partnership interest. Thus, in order for the partnership to use the liquidation value safe harbor, the IRS and the Treasury Department believe that the partnership and all of its partners must report consistently.

One commenter suggested that taxpayers should not be able to selectively exploit to their benefit the discrepancy between liquidation value and fair market value and suggested that the final regulations require that a partnership apply a consistent valuation methodology to all equity issued in any debt-for-equity exchange that is part of the same overall transaction. The IRS and the Treasury Department agree, and therefore the final regulations add this as a condition to the liquidation value safe harbor.

The third requirement of the liquidation value safe harbor in the proposed regulations is the arm's-length requirement. Commenters requested that the final regulations clarify whether this requirement can be satisfied where the exchange is between the partnership and an existing partner. The IRS and the Treasury Department believe that the liquidation value safe harbor should be available where the transaction involves related parties and have clarified this requirement in the final regulations to provide that, as long as the debt-for-equity exchange has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests, the third requirement is satisfied even if the transaction is between related parties.

The fourth requirement of the liquidation value safe harbor in the proposed regulations is an anti-abuse provision. The final regulations follow the anti-abuse provision of the proposed regulations by adding a restriction on subsequent purchases of the debt-for-equity interest by a person related to any partner (in addition to purchases by a person related to the partnership) as part of a tax-avoidance plan. Thus, under the final regulations, the partnership cannot redeem and no person related

to the partnership or to any partner can purchase the debt-for-equity interest as part of a plan at the time of the debt-for-equity exchange that has as a principal purpose the avoidance of COD income by the partnership. Commenters requested that the final regulations clarify the meaning of “related” in this context. The IRS and the Treasury Department agree that clarification is warranted and therefore the final regulations refer to sections 267(b) and 707(b) for the meaning of “related” in the anti-abuse provision.

The final regulations also address the application of the liquidation value safe harbor rule to a partnership (upper-tier partnership) that directly or indirectly owns an interest in one or more partnerships (lower-tier partnership(s)). The final regulations provide that, with respect to interests held in one or more lower-tier partnerships, the liquidation value of an interest in an upper-tier partnership is determined by taking into account the liquidation value of such lower-tier partnership interest.

The final regulations provide that if the fair market value of the debt-for-equity interest does not equal the fair market value of the indebtedness exchanged, then general tax law principles shall apply to account for the difference. Moreover, section 707(a)(2)(A), as it relates to the treatment of payments to partners for transfers of property, will be considered, if appropriate.

## 2. Application of Section 721 to Debt-for-Equity Exchanges

The proposed regulations generally provide that the nonrecognition rule of section 721 applies to the debt-for-equity exchange. Under the proposed regulations, the creditor does not recognize a loss or a bad debt deduction in the debt-for-equity exchange. The creditor’s basis in the debt-for-equity interest is increased under section 722 by the adjusted basis of the indebtedness. The preamble to the proposed

regulations requested comments on alternative approaches.

A number of commenters agreed with the general application of section 721 to the debt-for-equity exchange, but recommended that the rule be modified in the final regulations. The commenters argued that the application of section 721 to the debt-for-equity exchange may result in asymmetry in the timing of the partnership's COD income inclusion and the creditor's loss, character conversion for the creditor from ordinary loss to capital loss, and disparities between the partners' aggregate bases in their partnership interests and the partnership's basis in its assets. Some commenters suggested that these results could be alleviated if the final regulations bifurcate the debt-for-equity exchange into two transactions, namely the cancellation of a portion of the indebtedness, and the contribution of the balance in exchange for an interest in the partnership in a transaction to which section 721 applies (bifurcation approach). Another commenter, however, stated that a bifurcation approach is not consistent with section 721 or case law.

The IRS and the Treasury Department agree with the latter comment and believe that the bifurcation approach would be inconsistent with the treatment of analogous corporate debt-for-equity transactions involving corporate indebtedness evidenced by a security in which section 351 would apply, for example. Further, comments in favor of the bifurcation approach assume a creditor has not validly taken a bad debt deduction under section 166 prior to the debt-for-equity exchange in a transaction independent of and separate from the debt-for-equity exchange. After consideration of the issue, the IRS and the Treasury Department have determined that the final regulations will not adopt the bifurcation approach.



### 3. Obligations for Unpaid Rent, Royalties, and Interest

The proposed regulations provide that section 721 does not apply to the transfer of a partnership interest to a creditor in satisfaction of a partnership's recourse or nonrecourse indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount). These items generally give rise to ordinary income to the creditor and a deduction to the partnership. Most commenters agreed that the general nonrecognition rule under section 721 should not apply to the transfer of a partnership interest in satisfaction of these items. The IRS and the Treasury Department believe that the exception to section 721 for these items is necessary to prevent the conversion of ordinary income into capital gain.

The final regulations retain the exception for these ordinary income items, but, in response to a comment, limit the scope of the exception. The commenter suggested that the exception be limited to items that accrued on or after the beginning of the creditor's holding period for the indebtedness. The IRS and the Treasury Department agree with the comment, and therefore, the final regulations provide that section 721 does not apply to a debt-for-equity exchange to the extent the partnership interest is exchanged for the partnership's indebtedness for unpaid rent, royalties, or interest on the partnership's indebtedness (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness.

The preamble to the proposed regulations states the general rule that when property is transferred as payment on indebtedness (or in satisfaction thereof), gain or loss on the property is recognized. Under that approach, in a debt-for-equity exchange, if the partnership is treated as satisfying its indebtedness for unpaid rent, royalties, or

interest on indebtedness (including accrued original issue discount) with a fractional interest in each asset of the partnership, the partnership could recognize gain or loss equal to the difference between the fair market value of each partial asset deemed transferred to the creditor and the adjusted basis in that partial asset. The IRS and the Treasury Department believe that in a debt-for-equity exchange where the partnership has not disposed of any of its assets, the partnership should not be required to recognize gain or loss on the transfer of a partnership interest in satisfaction of its indebtedness for unpaid rent, royalties, or interest. Therefore, under the final regulations, a debtor partnership will not recognize gain or loss upon the transfer of a partnership interest to a creditor in a debt-for-equity exchange for unpaid rent, royalties, or interest that accrued on or after the beginning of the creditor's holding period for the indebtedness.

#### 4. COD Income as First-tier Item for Minimum Gain Chargeback Rules

The preamble to the proposed regulations requested comments regarding the manner in which COD income arising from a debt-for-equity exchange should be treated for purposes of the minimum gain chargeback rules under §1.704-2(f)(6). Section 1.704-2(f)(6) provides that any minimum gain chargeback required for a partnership taxable year consists first of certain gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities and then, if necessary, of a pro rata portion of the partnership's other items of income and gain for that year. A similar rule applies to chargebacks of partner nonrecourse debt minimum gain. See §1.704-2(i)(4).

Commenters recommended that, where a minimum gain chargeback results from

the discharge of partnership or partner nonrecourse debt, the first-tier of the minimum gain chargeback should include COD income relating to such debt. The IRS and the Treasury Department agree with this comment, and therefore the final regulations provide that COD income arising from a discharge of a partnership or partner nonrecourse indebtedness is treated as a first-tier item for minimum gain chargeback purposes under §§1.704-2(f)(6), 1.704-2(j)(2)(i)(A), and 1.704-2(j)(2)(ii)(A).

#### 5. Disposition of Installment Obligations

Section 453B provides rules regarding dispositions of installment obligations. Generally, if an installment obligation of a taxpayer is satisfied at other than its face value or the taxpayer distributes, transmits, sells, or otherwise disposes of an installment obligation, the taxpayer recognizes any deferred gain or loss. However, §1.453-9(c)(2) provides that the contribution of an installment obligation to a partnership under section 721, for example, does not constitute a disposition. The IRS and the Treasury Department believe that this exception does not apply to a creditor who disposes of an installment obligation of a partnership by contributing it to the debtor partnership, even if the transaction qualifies under section 721. In that case, the creditor must recognize gain or loss under section 453B. This treatment is consistent with the corporate rules that require a creditor to recognize gain or loss under section 453B on the disposition of an installment obligation of a corporation to the debtor corporation in a transaction that qualifies under section 351. Rev. Rul. 73-423 (1973-2 CB 161), (see §601.601(d)(2)(ii)(b)). Accordingly, the IRS and the Treasury Department are proposing regulations under section 453B to clarify this issue.

#### 6. Additional Issues

The preamble to the proposed regulations requested comments on whether any special allocation rules of COD income should apply where partnership indebtedness owed to a preexisting partner is satisfied with the transfer of a partnership interest. The proposed regulations did not address this issue. Commenters recommended that the final regulations not impose any special allocation rules regarding COD income realized under section 108(e)(8) from the cancellation of a partnership indebtedness owed to a preexisting partner. Commenters suggested that Rev. Rul. 92-97 (1992-2 CB 124) and Rev. Rul. 99-43 (1999-2 CB 506), (see §601.601(d)(2)(ii)(b)), provide an appropriate framework for determining how COD income should be allocated, whether or not the creditor is a partner in the partnership. The IRS and the Treasury Department agree that existing guidance provides a framework for allocating COD income and, thus, the final regulations do not adopt any additional guidance regarding the allocation of COD income among partners in a debt-for-equity exchange.

### **Effective/Applicability Date**

These final regulations apply to debt-for-equity exchanges occurring on or after the date these final regulations are published in the **Federal Register**.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section

7805(f) of the Code, the notice of proposed rulemaking that preceded these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Drafting Information**

The principal authors of these regulations are Joseph R. Worst and Megan A. Stoner of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Adoption of Amendment to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

### **PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.108-8 is added to read as follows:

#### **§1.108-8 Indebtedness satisfied by partnership interest.**

(a) In general. For purposes of determining income of a debtor from discharge of indebtedness (COD income), if a debtor partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of its recourse or nonrecourse indebtedness (a debt-for-equity exchange), the partnership is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the partnership interest.

(b) Determination of fair market value--(1) In general. All the facts and circumstances are considered in determining the fair market value of a partnership interest transferred by a debtor partnership to a creditor in satisfaction of the debtor partnership's indebtedness (debt-for-equity interest) for purposes of paragraph (a) of this section. If the fair market value of the debt-for-equity interest does not equal the fair market value of the indebtedness exchanged, then general tax law principles shall apply to account for the difference.

(2) Safe harbor--(i) General rule. For purposes of paragraph (a) of this section, the fair market value of a debt-for-equity interest is deemed to be equal to the liquidation value of the debt-for-equity interest, as defined in paragraph (b)(2)(iii) of this section, if the following requirements are satisfied--

(A) The creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange;

(B) If, as part of the same overall transaction, the debtor partnership transfers more than one debt-for-equity interest to one or more creditors, then each creditor, debtor partnership, and its partners treat the fair market value of each debt-for-equity interest transferred by the debtor partnership to such creditors as equal to its liquidation value;

(C) The debt-for-equity exchange is a transaction that has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests; and

(D) Subsequent to the debt-for-equity exchange, the debtor partnership does not

redeem the debt-for-equity interest, and no person bearing a relationship to the debtor partnership or its partners that is specified in section 267(b) or section 707(b) purchases the debt-for-equity interest, as part of a plan at the time of the debt-for-equity exchange that has as a principal purpose the avoidance of COD income by the debtor partnership.

(ii) Tiered-partnership rule. For purposes of this paragraph (b)(2), the liquidation value of a debt-for-equity interest in a partnership (upper-tier partnership) that directly or indirectly owns an interest in one or more partnerships (lower-tier partnership(s)) is determined by taking into account the liquidation value of such lower-tier partnership interests.

(iii) Definition of liquidation value. For purposes of this paragraph (b)(2), the liquidation value of a debt-for-equity interest equals the amount of cash that the creditor would receive with respect to the debt-for-equity interest if, immediately after the debt-for-equity exchange, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles) for cash equal to the fair market value of those assets and then liquidated.

(c) Example. The following example illustrates the provisions of this section:

Example. (i) AB partnership has \$1,000 of outstanding indebtedness owed to C. C agrees to transfer to AB partnership the \$1,000 indebtedness in a debt-for-equity exchange for a debt-for-equity interest in AB partnership. The liquidation value of C's debt-for-equity interest is \$700, which is the amount of cash that C would receive with respect to that interest if, immediately after the debt-for-equity exchange, AB partnership sold all of its assets for cash equal to the fair market value of those assets and then liquidated. Each of the requirements of the liquidation value safe harbor described in paragraph (b)(2) of this section is satisfied.

(ii) Because the requirements in paragraph (b)(2) of this section are satisfied, the fair market value of C's debt-for-equity interest in AB partnership for purposes of determining AB partnership's COD income is the liquidation value of C's debt-for-equity interest, or \$700. Accordingly, AB partnership is treated as satisfying the \$1,000 indebtedness for \$700 under section 108(e)(8).

(d) Effective/applicability date. This section applies to debt-for-equity exchanges occurring on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Par. 3. Section 1.704-2 is amended as follows:

1. In paragraph (f)(6), the first sentence is revised and in the last sentence, the language “(j)(2)(i) and (iii)” is removed and the language “(j)(2)(i) and (j)(2)(iii)” is added in its place.

2. Paragraphs (j)(2)(i)(A) and (j)(2)(ii)(A) are revised.

3. In paragraph (l), revise the paragraph heading and add a new paragraph (l)(1)(v).

The revisions and additions read as follows:

**§1.704-2 Allocations attributable to nonrecourse liabilities.**

\*\*\*\*\*

(f) \* \* \*

(6) \* \* \* Any minimum gain chargeback required for a partnership taxable year consists first of a pro rata portion of certain gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities and income from the discharge of indebtedness relating to one or more partnership nonrecourse liabilities to which partnership property is subject, and then, if necessary, consists of a pro rata portion of the partnership’s other items of income and gain for that year.\* \* \*

\* \* \* \* \*

(j) \* \* \*



(2) \* \* \*

(i) \* \* \*

(A) First, a pro rata portion of gain from the disposition of property subject to partnership nonrecourse liabilities and discharge of indebtedness income relating to partnership nonrecourse liabilities to which property is subject;

\* \* \* \* \*

(ii) \* \* \*

(A) First, a pro rata portion of gain from the disposition of property subject to partner nonrecourse debt and discharge of indebtedness income relating to partner nonrecourse debt to which property is subject.

\* \* \* \* \*

(l) Effective/applicability dates. \* \* \*

(1) \* \* \*

(v) The first sentence of paragraph (f)(6) of this section and paragraphs (j)(2)(i)(A) and (j)(2)(ii)(A) of this section apply on and after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

\* \* \* \* \*

Par. 4. Section 1.721-1 is amended by adding new paragraph (d) to read as follows:

§1.721-1 Nonrecognition of gain or loss on contribution.

\* \* \* \* \*

(d) Debt-for-equity exchange--(1) In general. Except as otherwise provided in section 721 and the regulations under section 721, section 721 applies to a contribution

of a partnership's indebtedness by a creditor to the debtor partnership in exchange for a capital or profits interest in the partnership (debt-for-equity exchange). See §1.108-8(a) for rules in determining the debtor partnership's discharge of indebtedness income.

(2) Exception. Section 721 does not apply to a debt-for-equity exchange to the extent the transfer of the partnership interest to the creditor is in exchange for the partnership's indebtedness for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness. The debtor partnership will not recognize gain or loss upon the transfer of a partnership interest to a creditor in a debt-for-equity exchange for unpaid rent, royalties, or interest (including accrued original issue discount).

(3) Cross reference. For rules in determining whether a partnership interest transferred to a creditor in a debt-for-equity exchange is treated as payment of interest or accrued original issue discount, see §§1.446-2 and 1.1275-2, respectively.

(4) Effective/applicability date. This paragraph (d) applies to debt-for-equity exchanges occurring on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Steven T. Miller  
Deputy Commissioner for Services and Enforcement.

Approved: November 8, 2011

Emily S. McMahon  
Acting Assistant Secretary of the Treasury.

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